



CROSSMANS

SOLICITORS

Crossmans Guide
Trusts



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What is a Trust?

A Trust is a legal arrangement under which certain people (the Trustees) hold legal ownership of an asset but other people (the Beneficiaries) are entitled to use the assets or to receive their income or to receive capital.

There are different ways in which one can benefit from an asset. In the case of a house for example, one can live in it, receive its rent or receive the sale proceeds when it is sold. Another benefit is being able to leave the house by will to whoever you want.

The practical reason why trusts are so useful is that it makes it possible to give one type of benefit to one person and another benefit from the same asset to another person.

For example a Will might contain a clause saying "I give my house to my husband for life and subject to that to my children in equal shares absolutely". In this example the husband will have the right to live in the house for the rest of his life or to receive the rent from the house but when he dies the house will pass to the children. The husband has certain ownership benefits (the right to live in the house or receive its income) but he does not have other ownership benefits (the right to leave the house in his Will or to receive the sale proceeds or capital represented by the house). The trust ensures that the husband will have a roof over his head but at the same time that the house will pass to children when the husband dies.

In these notes three common types of trusts are described. These are interest in possession trusts, discretionary trusts and accumulation and maintenance trusts.

Interest in Possession Trusts

This is a simple trust of the type described above. A particular beneficiary or beneficiaries has a right to use the trust asset or receive its income for a certain period (for example for life) and another specified beneficiary or beneficiaries has a right to receive the trust capital when that period comes to an end.

Inheritance Tax Treatment of an Interest in Possession Settlement

On creation of the trust :

The transfer of assets into an interest in possession settlement is a potentially exempt transfer. This means that it is not a chargeable transfer at the time the gift is made and it will become an exempt transfer if the person making the gift remains alive for seven years after the date of the gift. If the person making the gift dies within that time the value of the gift will have to be brought into account when calculating the inheritance tax payable on the donor's death.



While the Trust Continues:

The beneficiary who has a right to receive the income of the fund is treated as if they owned the fund so there is no charge to tax as long as that beneficiary's right to the income of the fund continues.

On the death of the beneficiary the value of the trust fund (or a proportion of the trust fund corresponding to that beneficiary's share of income) will be added onto the beneficiary's own estate; the beneficiary's nil rate band will be deducted and inheritance tax at 40% is calculated on the balance of the total. The tax is apportioned between the trust on the one hand and the beneficiary's estate on the other

Capital Gains Tax

On creating the trust :

The transfer of assets into an interest into an interest in possession settlement is a chargeable disposal for capital gains tax purposes so capital gains tax may be payable unless some other relief is available.

While the trust continues:

If assets are sold during the lifetime of the trust the trustees are liable to capital gains tax in the normal way again unless other relieves are available.

If a beneficiary becomes absolutely entitled to the trust assets otherwise if on the death of a beneficiary there is a deemed transfer by the trustees and again capital gains tax may be payable.

On the death of a beneficiary:

On the death of a beneficiary the trustees are treated as if they have disposed of the assets and immediately reacquired them at their value at the date of the beneficiary's death but this deemed disposal does not give rise to a charge to inheritance tax so effectively the trust gets a trust free uplift in base value.

Income Tax

If the trust assets produce income and if the income is paid to the trustees they are liable for inheritance tax at the standard rate. If the income is paid direct to the beneficiary the trustees are not liable for income tax; it is included in the beneficiary's tax return and is treated as the beneficiary's income not that of the trustees.

Discretionary Trusts

A discretionary trust is one under which, instead of there being a specific beneficiary or beneficiaries entitled to the use of trust assets or trust income and other specific beneficiaries who are entitled to the capital, there is a class of potential beneficiaries and it is for the trustees to decide at their discretion to whom they will pay income or capital. None of the potential beneficiaries have an absolute right to benefit from the trust fund whether in terms of using trust assets, receiving their income or receiving capital; it is up to the trustees to decide.



Inheritance tax

As we have seen the inheritance tax regime regards a beneficiary of an interest in possession trust as if they owned the underlying trust asset because they have an absolute right to benefit from the trust fund. Under a discretionary trust no one has an absolute right to benefit from the fund and so no individual beneficiary is treated as if they owned any share in the trust fund. The trust has its own inheritance tax regime and its own nil rate band.

Creation of a Discretionary Trust:

The transfer of assets to a discretionary trust is a chargeable transfer and if the value of the assets put into the trust exceeds the settlor's nil rate band there will be an immediate charge to inheritance tax at the lifetime rate of 20%.

During the Lifetime of the Trust:

On every tenth anniversary of the creation of a discretionary trust the trust fund is valued and if its value exceeds the current nil rate band the trustees must pay inheritance tax at the rate of 6% on that excess.

When assets are transferred out of the trust (or if the trustees decide to give a beneficiary an interest in possession) there is an exit charge on the value of the assets leaving the trust. The exit charge will be a proportion of the periodical charge for example if the assets leave the trust halfway through a ten year cycle the charge will be 50% of the charge that would have applied on the tenth anniversary.

Death of a beneficiary:

Because none of the beneficiaries have a right to benefit from a discretionary trust when a beneficiary dies they are not treated as if they owned any part of the trust fund even if, as a matter of fact, they have had the benefit of the fund whilst alive. This makes discretionary trusts useful tools for inheritance tax planning

Capital Gains Tax

On creation of a discretionary trust:

When a transferor transfers assets to a discretionary trust hold over relief is available. In other words the trustees would take over the assets at their base value in the hands of the transferor and the charge to tax is postponed.

While the trust continues:

If the transferees dispose of assets during the lifetime of the trust they are liable to capital gains tax at the rate applicable to trusts (40%). When assets leave the trust or if the trustees decide to give a beneficiary an interest in possession in those assets this is treated as a chargeable disposal and again the trustees will be liable to capital gains tax.

On the death of a beneficiary:

The death of a beneficiary does not affect the trustees' capital gains tax position



Income Tax

The trustees are liable to income tax on trust income at the rate applicable to trusts (32.5% for dividends and 40% for other income).

Accumulation and Maintenance Trust

An accumulation and maintenance trust (A & M Trust) is a special type of trust for children. Provided certain conditions are fulfilled an A & M Trust attract certain tax benefits. The two principal conditions are:-

- That one or more persons (beneficiaries) will, on or before attaining a specified age not exceeding 25, become beneficially entitled to the trust property or to an absolute right to receive its income and;
- Until that time the beneficiary does not have an absolute right to receive the trust income or a share of the trust income, instead the income is to be accumulated insofar as it is not applied for the maintenance educational benefit of the beneficiary

Inheritance Tax

Creation of an A and M Trust:

The transfer of property to an A and M Trust is treated as a potentially exempt transfer.

While the A and M trust continues there is no periodical charge to inheritance tax when every tenth anniversary of an A & M Trust.

When an A and M trust ends there is no charge to inheritance tax when a beneficiary becomes entitled to an interest in possession in the trust fund.

Capital Gains Tax

Creation of an A and M trust:

The transfer of assets into an A & M settlement is a chargeable disposal for capital gains tax purposes so capital gains tax may be payable.

While the trust continues:

If the trustees realise gains on the disposal of assets during the trust period they may be liable for capital gains tax in the normal way. Capital gains tax is charged at the rate applicable to trusts which at present is 40%.

When the trust ends:

If a beneficiary becomes absolutely entitled to the trust assets when the A & M Trust ends there will be a charge to capital gains tax. However the trustees and the beneficiary may be able to claim hold over relief. This means that the beneficiary takes over the trust assets at their base value at the hands of the trustees so effectively the charge to capital gains tax is postponed until the beneficiary actually sells the assets.



Income Tax

The trustees pay income tax on trust income at the rate applicable to trusts (32.5% for dividends and 40% for other income). If income is paid out to a beneficiary or to a beneficiary's parent for the maintenance educational benefit of that beneficiary a tax claim may be made on the beneficiaries behalf to claim back the tax that has been paid.